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C O N F I D E N T I A L SECTION 01 OF 02 BEIJING 003240

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Classified By: Econ Minister Counselor William Weinstein. Reasons: 1.5 (b) and (d).

¶1. (SBU) SUMMARY: China's national-level regulation over both domestic and foreign private-equity (PE) firms is in flux as Beijing's various regulatory bodies engage in a turf war over who will lead reform efforts and ultimately control industry regulations, several well-connected Embassy contacts recently told Econoffs. Although Beijing supports the development of a homegrown PE industry, Chinese PE firms have a long way to go, our contacts said. Experts are divided on the question of whether Chinese individuals and institutions would grow more willing to act as limited partners (LPs) by giving their funds to a general partner (GP), who would have ultimate say in deciding on projects in which to invest.

Note: This is the first in a series of three cables regarding China's nascent domestic Private Equity (PE) industry, the opportunities and challenges of foreign PE firms in China, and Beijing's actions to shape the regulatory landscape. EconOffs in October and November 2009 met with industry experts from foreign and Chinese private equity firms to discuss present conditions and trends in China's PE industry. End Summary.

¶2. (SBU) An October Deloitte and Touche survey reported that 93 percent of current market participants expect China's PE industry to expand and to include entries by new funds and more active investment vehicles. Almost half of the respondents also believed local investors would account for the majority of new issuances and fund launches through October 2010. "PE started very late, but has grown very fast," according to Chinese PE firm Hony Capital CEO John Zhao. "The demand is there. The economy is growing. New companies will form, and there won't be enough capital." Another contact who works for a small U.S. PE firm agreed, noting that one of China's biggest looming problems was a lack of capital to funnel to its small and medium-sized enterprises. "PE has a big role to play in filling that gap. U.S. PE believes that, and the Chinese government believes it too," according to the contact.

"WE WILL ARGUE ABOUT PE REGULATION FOR ANOTHER YEAR"

¶3. (SBU) Hony's Zhao told EconOffs on November 4 that China's financial regulatory bodies favored a growing PE industry, but that each agency was vying to lead regulatory reform efforts. Zhao, who was a senior advisor to a NDRC-led working group on PE regulatory reform, noted that NDRC originally argued China should not regulate PE at all, but

subsequently reversed course by announcing it would lead reform efforts. Its frontrunner status was seemingly reinforced by the "Opinions Regarding Deepening of Systemic Economic Reform" issued by the State Council in May 2009, in which NDRC was instructed to take the lead on PE regulations. NDRC in August 2009 submitted draft PE Regulations to the State Council. Xu Lin, NDRC's Director General for the Department of Fiscal and Financial Affairs, told the 2009 Annual Beijing Global PE Forum on November 9 that NDRC wanted "moderate" regulation for the private equity industry, and that PE firms would be subject to the supervision of the local governments where they were registered. A China Securities Regulatory Commission official, however, stated China should legally treat PE firms as public entities and heavily regulate them at the national level. This official displayed no awareness of the irony in his insistence that "private" equity be treated as though it were "public."

¶4. (SBU) Hony's Zhao said this debate had been carried to the State Council. National People's Congress Financial and Economic Affairs Committee Vice Chair Wu Xiaoling led efforts to reform the current law covering investment within China, which originally included only mutual funds. The regulatory reform working group was working with Wu to define PE firms as private entities within the law. According to Zhao, "Madame Wu clearly understands this. She knows any attempt to make this a turf war will take a lot of time." Wu hoped the law would define clearly the roles, rights, and obligations of PE investors and general partners, according to a November 10 Global Times report on her speech to the Annual Beijing Global PE Forum.

¶5. (C) PE firms did not object to this turf war because it allowed them to "do what they want," according to Zhao. (See septel for the mechanisms firms used to circumvent prohibitive regulations.)

NEXT STEPS

¶6. (SBU) Hony's Zhao thought the next big change for the PE industry would be increasing numbers of individuals and institutions acting as limited partners by providing funds to a larger pool, rather than insisting on becoming the general partner with the ability to choose projects. Zhao said this trend was being fueled by the realization among these actors that managing money successfully required specialized knowledge and a lot of hard work. (Note: All of the industry experts told EconOffs that, historically, Chinese investors have wanted to be general partners to retain better control of their own money. RMB onshore funds with Chinese investors willing to let fund managers manage their money for them would signal a significant shift in investors' attitudes toward their own money. End Note) In contrast, Carlyle's Eric Zhang told Embassy officials that private Chinese entities could contribute money as LPs, but they would not be a major force despite China's newfound wealth.

¶7. (C) COMMENT: PE clearly will play a major role in China's capital markets as they develop, but some Chinese government officials continue to struggle with an ideological aversion to the idea of large amounts of capital being managed outside direct government oversight. While the current turf war leaves gaps for PE firms to exploit, regulations appear to be increasingly seeking to favor domestic firms at the expense of foreign PE. At the same time, however, regulatory agencies appear to be aware that the domestic industry still relies on foreign expertise. The government probably will continue to balance these conflicting agendas over the next three to five years, but we expect a gradual "crowding out" of foreign firms as domestic companies gain experience. END COMMENT
HUNTSMAN